A Report
to the
Montana
Legislature

Financial-Compliance Audit

# Montana State Fund

## For the Calendar Year Ended
## December 31, 2016

August 2017

Legislative Audit
Division

*17-05A*

## Legislative Audit Committee



Fraud Hotline
(Statewide)
1-800-222-4446
(in Helena)
444-4446
ladhotline@mt.gov

## Financial-Compliance Audits

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act Amendments of 1996 and the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards require the auditor to issue certain financial, internal control, and compliance reports in addition to those reports required by Government Auditing Standards. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2015, was issued March 29, 2016. The Single Audit Report for the two fiscal years ended June 30, 2017, will be issued by March 31, 2018.

### Audit Staff


Abbie Caldwell
Chris G. Darragh
Shandell VanDonsel
Miki Cestnik
Alexa O'Dell
Kelly Zwang


Reports can be found in electronic format at:
http://leg.mt.gov/audit

# LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

August 2017

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report of the Montana State Fund, a component unit of the state of Montana, for the calendar year ended December 31, 2016. The calendar year 2016 financial statements present the first full calendar year of operations since Montana State Fund's fiscal year changed in accordance with state law. This report does not contain any recommendations, and we issued an unmodified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page C-1. We thank the Montana State Fund President/CEO and his staff for their cooperation and assistance during the audit.

Respectfully submitted,

*/s/ Angus Maciver*

Angus Maciver
Legislative Auditor

Room 160 • State Capitol Building • PO Box 201705 • Helena, MT • 59620-1705
Phone (406) 444-3122 • FAX (406) 444-9784 • E-Mail lad@mt.gov

# Table of Contents


Appointed and Administrative Officials ....................ii
Report Summary ....................S-1

**CHAPTER I – INTRODUCTION ....................1**
Introduction ....................1
Background ....................1

**INDEPENDENT AUDITOR'S REPORT**
Independent Auditor's Report ....................A-1

**MONTANA STATE FUND FINANCIAL STATEMENTS**
Montana State Fund Management Discussion and Analysis ....................A-5
Statement of Net Position ....................A-11
Statement of Revenue, Expenses, and Changes in Fund Net Position ....................A-12
Statement of Cash Flows ....................A-13
Notes to Financial Statements ....................A-15
Required Supplementary Information ....................A-42

**REPORT ON INTERNAL CONTROL AND COMPLIANCE**
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* ....................B-1

**STATE FUND RESPONSE**
Montana State Fund ....................C-1

## Appointed and Administrative Officials

| | | |
|---|---|---|
| **Montana State Fund** | Laurence Hubbard, President/CEO | |
| | Mark Barry, Vice President, Corporate Support | |
| | Richard Duane, Vice President, Human Resources | |
| | Julie Jenkinson, Vice President, Insurance Operations | |
| | Denise Heigh, Vice President, Insurance Operations Support | |
| | Kevin Braun, Vice President, General Counsel | |
| | Al Parisian, Vice President, Chief Information Officer | |
| | | Term Expires |
| **State Fund Board of Directors** | Lance Zanto, Chair | 2017 |
| | Matthew C. Mohr | 2019 |
| | Bruce Mihelish | 2017 |
| | Richard Miltenberger | 2017 |
| | Lynda Moss | 2017 |
| | Jack Edward Owens | 2019 |
| | Jan VanRiper | 2019 |
| | Laurence Hubbard, President/CEO - ex officio nonvoting member | |

For additional information concerning the Montana State Fund, contact:

Laurence Hubbard, President/CEO
855 Front Street
Helena, MT 59604
(406) 495-5015

e-mail: lhubbard@mt.gov

Montana Legislative Audit Division

# Financial-Compliance Audit
# Montana State Fund
## For the Calendar Year Ended December 31, 2016

August 2017 17-05A Report Summary

Effective January 1, 2016, Montana State Fund is under the regulatory authority of the Insurance Commissioner at the State Auditor's Office and operates on a calendar year. As part of our work, we considered the transactions and activities to convert operations to a calendar year. Under this change MSF is also subject to additional reporting requirements and must submit the rates they set for review and approval by the Insurance Commissioner.

## Context

Montana State Fund (MSF) is established by Title 39, Chapter 71 of the Montana Code Annotated. Operating as a nonprofit, independent public corporation, MSF functions like a private insurance carrier in a competitive marketplace to guarantee coverage to all employers in Montana. MSF is governed by a seven-member board of directors appointed by the Governor. The board of directors appoints the President/CEO who oversees MSF's day-to-day operations.

In accordance with state law MSF is under the regulatory authority of the Insurance Commissioner at the State Auditor's Office (commissioner) for claims occurring after July 1, 1990. The commissioner does not have any authority over claims occurring before July 1, 1990, referred to as the old fund claims, which are an obligation of the primary government and are reflected on the state of Montana's financial statements.

MSF does not receive funding from the General Fund. Revenue from insurance premiums and investments income support operations. In calendar year 2016 insurance premium revenue and investment income totaled $170 million and $50 million, respectively. Expenses are primarily the payment of injured workers' claims which totaled $131 million in calendar year 2016. The calendar year 2016 financial statements present the first full calendar year of operations.

## Results

We performed work over MSF internal controls and business processes related to the payment of claim expenses, reserves for future claims, collection of insurance premium revenue, investment activity, reinsurance activity, and compliance with selected laws and regulations. We also considered the overall reasonableness of the financial statement presentation.

We issued an unmodified opinion on the financial statement's, meaning the reader can rely on the information presented, and this report does not contain any recommendations. The prior report also did not contain recommendations to MSF.

For a complete copy of the report (17-05A) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to **lad@mt.gov**; or check the web site at
**http://leg.mt.gov/audit**
Report Fraud, Waste, and Abuse to the Legislative Auditor's FRAUD HOTLINE
Call toll-free 1-800-222-4446, or e-mail **lad@mt.gov.**

# Chapter I – Introduction

## Introduction

We performed a financial-compliance audit of the Montana State Fund (MSF) for the calendar year ended December 31, 2016. MSF is the only state agency operating on a calendar year.

The objectives of this audit were to:

1. Determine whether the MSF's financial statements present fairly the financial position, results of operations, and cash flows for the calendar year ended December 31, 2016.
2. Obtain an understanding of the MSF's control systems to the extent necessary to support our audit of MSF's financial statements, and if appropriate, make recommendations for improvement.
3. Determine whether MSF complied with selected applicable laws and regulations.

Our audit work included testing of MSF internal controls and business processes related to:

- Payment of claim expenses and reservations for future claims.
- Assessment and collection of policy premiums.
- Investment activity.
- Reinsurance activity.
- Transactions and activities at calendar year-end.
- Compliance with selected laws and regulations.
- Overall reasonableness of the financial statement presentations.

MSF personnel prepared the management discussion and analysis, financial statements and notes, and the required supplementary information beginning on page A-5 based on accounting information from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustments. Adjustments are made to present financial activity in accordance with Generally Accepted Accounting Principles (GAAP).

## Background

MSF is a state agency operating as a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance, and guarantees available coverage for all employers in Montana. MSF is governed by a seven-member board of directors appointed by the Governor.

MSF's Board of Directors must set premium rates for claims incurred after July 1, 1990, at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of MSF, and to maintain a surplus over a calculated amount based on the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The investments of the MSF, per state law, are managed by the Montana Board of Investments.

Pursuant to §39-71-2375 of the Montana Code Annotated, effective January 1, 2016, MSF is under the regulatory authority of the Insurance Commissioner at the State Auditor's Office (commissioner) for claims incurred after July 1, 1990. The commissioner does not have any authority over claims occurring before July 1, 1990, referred to as the old fund claims, which are an obligation of the primary government and are reflected on the state of Montana's Financial Statements. The MSF reporting period changed to a calendar-year basis, and the calendar year 2016 financial statements present the first full calendar year of operations since the change in law took effect. Under the new law, by March 1 of each year, MSF is required to submit financial statements in a regulatory format to the Insurance Commissioner. Financial statements, completed in accordance with GAAP, will also continue to be prepared by Montana State Fund. This audit of GAAP financial statements remains a requirement per §39-71-2361, MCA, and continues to be necessary to support our audit of the state's basic financial statements.

# Independent Auditor’s Report

LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

# Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

***Introduction***

We have audited the accompanying Statement of Net Position of the Montana State Fund as of December 31, 2016, the related Statement of Revenues, Expenses and Changes in Fund Net Position, and the Statement of Cash Flows for the calendar year then ended, and the related notes to the financial statements which collectively comprise the Montana State Fund's basic financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this responsibility includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the Montana State Fund's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Montana State Fund's internal control, and accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Room 160 • State Capitol Building • PO Box 201705 • Helena, MT • 59620-1705
Phone (406) 444-3122 • FAX (406) 444-9784 • E-Mail lad@mt.gov

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the net position of the Montana State Fund as of December 31, 2016, and the changes in net position and cash flows for the calendar year then ended in conformity with accounting principles generally accepted in the United States of America.

***Emphasis of Matter***

As discussed in Note 1 to the financial statements, the financial statements referred to above for the calendar year ended December 31, 2016, present the first full calendar year of operations since the change in law took effect. The financial statements for the year ended December 31, 2015, presented six months of operations. Our opinion is not modified with respect to this matter.

***Other Matters***

*Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the Managements' Discussion and Analysis and the risk management, retirement, and other post-employment benefits Required Supplementary Information be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated June 8, 2017, on our consideration of the Montana State Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Montana State Fund's internal control over financial reporting and compliance.

Respectfully submitted,

*/s/ Cindy Jorgenson*

Cindy Jorgenson, CPA
Deputy Legislative Auditor
Helena, MT

June 8, 2017

# Montana State Fund Financial Statements

**Montana State Fund**
(A Component Unit of the State of Montana)
Management Discussion and Analysis
December 31, 2016

Montana State Fund (MSF) is a self-sufficient, not-for-profit workers' compensation insurance carrier. Our statutory purpose is to act as a competitive insurance carrier, providing an available market and thereby guaranteeing coverage to all employers in Montana. Operating on the premium dollars paid by the insured employers and the net proceeds from our investments, MSF is not funded by the State general fund for primary business operations. We function like a private insurance carrier in a competitive marketplace and, as provided by law, perform all the functions and exercise all the powers of a private insurance carrier that are necessary, appropriate or convenient for the administration of the Montana State Fund.

MSF has undergone a number of changes since our creation in 1990. We continue to strive to improve efficiencies in all operational areas and have made a major investment in our safety management services as we work diligently with Montana employers in developing accident prevention programs. MSF has invested more resources for medical management and provider relations to improve our focus on managing medical costs as medical benefit costs are over half of total claim costs. A multiyear project is in progress to transition our legacy Policyholder Services system to allow for expanded customer and agent access to timely business information. During the 2015 Legislative session, legislation passed (SB123) transferring oversight of MSF to the State Auditor's Office, which regulates all insurance companies doing business in Montana. The first required NAIC Annual Statement that includes the 2016 financial results reported on a Statutory basis was filed with the State Auditor's Office in March 2017.

MSF also administers and manages the claims remaining in the Old Fund for the State of Montana. The assets of the Old Fund were completely liquidated in 2011 and benefit payments and administrative costs for claims occurring before July 1st, 1990, are fully supported by General Fund resources as required under state law (Section 39-71-2352, MCA). Therefore, the Old Fund is considered to be part of the Primary Government for financial reporting purposes and is not included in the accompanying financial statements.

## *Overview of the Financial Statements*

This overview is an introduction to Montana State Fund financial statements. The financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The Statement of Net Position presents information regarding all of MSF's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and total net position.

The Statement of Revenues, Expenses, and Changes in Fund Net Position presents the financial results of operations for MSF for the year ending December 31, 2016. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The Statement of Cash Flows details the cash used and provided by the various activities of MSF during the fiscal period. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the period.

***Financial Highlights***

Effective January 1, 2016, Montana State Fund moved under regulation by the State Auditor's Office and Title 33, Montana Insurance Code. In order for MSF financial reporting to convert from a fiscal year ending June 30th to a calendar year of January 1st to December 31st as required by the law, MSF issued financial statements as of and for the six-month period ended December 31, 2015. Accordingly, the comparability of the information presented below is affected since the current year information represents a 12-month, calendar-year period and the prior year information represents a six-month period.

MSF continues to deliver high-quality services to Montana businesses at the lowest possible cost consistent with sound insurance principles. MSF fosters and supports a competitive insurance market in Montana, offering a competitively priced product based upon actuarially sound rates while still fulfilling our role as the guaranteed market. The Board of Directors approved a 5% decrease in rates for the policy year covering July 1, 2015 to June 30, 2016 and held those rates constant for the policy year of July 1, 2016 to June 30, 2017. The Board of Directors recently approved a rate reduction of 5% for rates effective July 1, 2017.

MSF dividends return to employers a portion of premiums paid to MSF. It is a way for MSF to share our strong financial results with those employers who help make it possible by lowering workplace injuries. Total dividends of $70M (million) were declared in the last two years to qualifying policyholders. A $35M dividend was declared for the year ending December 31, 2015, followed by a $35M dividend declared in September 2016. The Board of Directors, based on analysis of policyholder surplus adequacy and financial results, approves the amount of dividends to be declared. MSF has declared and paid dividends for 18 consecutive years.

***Analysis of Financial Position and Results of Operations***

The following analysis presents comparative condensed financial data for MSF.

**Net Position (in thousands)**

| | 12/31/2016 | 12/31/2015 |
|---|---|---|
| Current and Other Assets | $ 226,796 | $ 242,088 |
| Capital Assets (Net) | 27,687 | 28,843 |
| Investments | 1,423,772 | 1,405,963 |
| Total Assets | 1,678,255 | 1,676,894 |
| Total Deferred Outflows of Resources | 3,407 | 1,187 |
| Current Liabilities | 256,365 | 272,095 |
| Long-term Liabilities | 899,915 | 889,268 |
| Total Liabilities | 1,156,280 | 1,161,363 |
| Total Deferred Inflows of Resources | 78 | 1,757 |
| Net Position: | | |
| Net Investment in Capital Assets | 27,687 | 28,843 |
| Unrestricted | 497,617 | 486,118 |
| Total Net Position | $ 525,304 | $ 514,961 |

MSF's overall net position increased during the year ended December 31, 2016, largely due to another year of strong investment performance. With around $1.7B in combined assets and deferred outflows of resources to meet $1.2B of liabilities and deferred inflows of resources, MSF is well-positioned to meet the commitments to policyholders that it has incurred, which is the hallmark of prudent insurance operations.

The largest component of MSF assets is investments, which increased slightly during the year ended December 31, 2016. The change in value is summarized in the following display (in thousands):

| | Year Ended 12/31/16 | Six Months Ended 12/31/15 |
|---|---|---|
| Prior Year Market Value | $ 1,405,963 | $ 1,421,359 |
| Purchases at Cost | 294,750 | 51,208 |
| Sales | (286,661) | (58,624) |
| Net Realized Gains | 11,280 | 984 |
| Net Accretion of Bonds | (388) | (101) |
| Unrealized Gain (Loss) | (1,171) | (8,863) |
| Current Year Market Value | $ 1,423,772 | $ 1,405,963 |

The most significant MSF liability is estimated claims payable, which increased slightly during the year ended December 31, 2016. This liability is increased as new claims for the year are added and decreased as claim payments are made. Additionally, changes to the estimates for prior years can increase or decrease the liability. The changes are summarized in the following display (in thousands):

| | Year Ended 12/31/16 | Six Months Ended 12/31/15 |
|---|---|---|
| Estimated Claims Payable - Beginning | 900,296 | 895,543 |
| Incurred Claims Payable | 131,254 | 67,383 |
| Claim Payments | (110,019) | (62,630) |
| Estimated Claims Payable - Ending | 921,531 | 900,296 |

Willis Towers Watson, an independent actuarial firm, prepares an annual actuarial study used to estimate claims liabilities for MSF and provides a range of potential costs associated with claims. MSF management selected and the Board of Directors approved an estimate within that range as the estimated claims payable, consisting of unpaid claims, reserve strengthening and claim adjustment expenses.

**Changes in Net Position (in thousands)**

| | Year Ended 12/31/2016 | Six Months Ended 12/31/2015 |
|---|---|---|
| Operating Revenues: | | |
| Net Premium Earned | $ 169,677 | $ 88,495 |
| Total Operating Revenue | 169,677 | 88,495 |
| Operating Expenses: | | |
| Benefits and Claims | 131,254 | 67,383 |
| Personal Services | 28,434 | 14,448 |
| Dividend Expense | 35,001 | 35,003 |
| Other Operating Expense | 15,903 | 7,252 |
| Total Operating Expense | 210,592 | 124,086 |
| Net Operating Income (Loss) | (40,915) | (35,591) |
| Nonoperating Revenue (Expense): | | |
| Investment Income | 49,844 | 12,500 |
| Other Nonoperating Revenue | 1,461 | 1,072 |
| Total Nonoperating Revenue (Expense) | 51,305 | 13,572 |
| Change in Net Position | 10,390 | (22,019) |
| Prior Period Adjustment | (47) | - |
| Beginning Net Position | 514,961 | 536,980 |
| Total Net Position | $ 525,304 | $ 514,961 |

For the year ended December 31, 2016, MSF produced an increase in net position of $10.3M after returning $35.0M in dividends to eligible policyholders. Net premium income for the year was approximately 192% of the amount for the six-month period ending December 31, 2015, indicating relatively consistent premium levels from period to period. Premium retention, or the amount of premium that was retained from the prior year, was approximately 91% for the year ended December 31, 2016, which is consistent with MSF's recent history.

The accident year ultimate loss, which is the expected ultimate cost of all claims incurred during the year, was approximately 193% of the prior six-month ultimate loss, indicating relatively stable expected loss experience from period to period.

Personal services and other operating expense levels remained relatively consistent from period to period. The amounts shown for the year ended December 31, 2016, are therefore roughly double the amounts of the six-month period ended December 31, 2015.

The final contributing factor in the $10.3M change in net position is MSF's investment income. While the rate of returns from the portfolio remained relatively constant throughout the 18 months shown above, MSF had significantly fewer realized gains during the six months ended December 31, 2015 than it did during the twelve months ended December 31, 2016. In addition, the amount of unrealized losses

on the portfolio were much smaller during 2016 than during the six months ended December 31, 2015. A combination of these factors resulted in investment income being nearly four times larger in 2016 than in the six months ended December 31, 2015.

An operating loss of ($5.9M) coupled with solid investment income and a $35M dividend resulted in a change in net position of $10.3M.

**Montana State Fund**
**Statement of Net Position**
*Montana State Fund is a component unit of the State of Montana*

| | | December 31, 2016 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and Cash Equivalents | $ | 35,091,741 |
| Receivables, Net | | 81,480,693 |
| Securities Lending Collateral | | 45,360,715 |
| Other Assets | | 2,248,502 |
| Total Current Assets | | 164,181,651 |
| **Noncurrent Assets** | | |
| Investments | | 1,423,772,415 |
| Reinsurance Receivables | | 62,613,491 |
| Capital Assets: | | |
| Land | | 1,139,460 |
| Other Capital Assets, Net of Depreciation | | 26,547,749 |
| Total Capital Assets | | 27,687,209 |
| Total Noncurrent Assets | | 1,514,073,115 |
| Total Assets | | 1,678,254,766 |
| **DEFERRED OUTFLOWS OF RESOURCES** | | |
| Deferred Pension Outflows | | 3,407,402 |
| **LIABILITIES** | | |
| **Current Liabilities** | | |
| Accounts Payable | | 10,004,780 |
| Estimated Claims Payable | | 128,265,148 |
| Unearned Premium | | 68,179,913 |
| Securities Lending Liability | | 45,360,715 |
| Compensated Absences | | 2,000,688 |
| Policyholder Deposits | | 2,554,035 |
| Total Current Liabilities | | 256,365,279 |
| **Noncurrent Liabilities** | | |
| Estimated Claims Payable | | 793,266,484 |
| Reinsurance Funds Withheld | | 75,739,328 |
| Net Pension Liability | | 23,632,903 |
| Other Post Employment Benefits | | 6,324,851 |
| Compensated Absences | | 951,127 |
| Total Noncurrent Liabilities | | 899,914,693 |
| Total Liabilities | | 1,156,279,972 |
| **DEFERRED INFLOWS OF RESOURCES** | | |
| Deferred Pension Inflows | | 78,225 |
| **NET POSITION** | | |
| Net Investment in Capital Assets | | 27,687,209 |
| Unrestricted | | 497,616,762 |
| Total Net Position | $ | 525,303,971 |

The notes to the financial statements are an integral part of this statement.

**Montana State Fund**
**Statement of Revenues, Expenses, and Changes in Fund Net Position**
*Montana State Fund is a component unit of the State of Montana*

| | | For the Year Ended December 31, 2016 |
|---|---|---|
| Net Premiums Earned | $ | 169,677,071 |
| Operating Expenses | | |
| Benefits and Claims | | 131,254,250 |
| Personal Services | | 28,433,522 |
| Contractual Services | | 5,616,917 |
| Supplies and Materials | | 831,188 |
| Communications | | 1,244,583 |
| Travel | | 219,522 |
| Rent and Utilities | | 567,756 |
| Repair and Maintenance | | 1,215,971 |
| Depreciation and Amortization | | 1,282,118 |
| Dividend Expense | | 35,000,685 |
| Other Operating Expenses | | 4,925,653 |
| Total Operating Expenses | | 210,592,165 |
| Operating Income (Loss) | | (40,915,094) |
| Nonoperating Revenue (Expenses) | | |
| Investment Income | | 49,844,049 |
| Securities Lending Income | | 394,635 |
| Securities Lending Expenses | | (170,549) |
| Other Income | | 1,236,857 |
| Total Nonoperating Revenue (Expenses) | | 51,304,992 |
| Change in Net Position | | 10,389,898 |
| Total Net Position - Beginning (As Previously Reported) | | 514,960,881 |
| Prior Period Adjustment | | (46,808) |
| Total Net Position - Beginning (As Restated) | | 514,914,073 |
| Total Net Position - Ending | $ | 525,303,971 |

The notes to the financial statements are an integral part of this statement.

**Montana State Fund**
**Statement of Cash Flows**
*Montana State Fund is a component unit of the State of Montana*

| YEAR ENDED DECEMBER 31, | 2016 |
|---|---|
| **Cash Flows from Operating Activities** | |
| Receipts for Premiums | 156,347,495 |
| Payments to Suppliers for Goods and Services | (13,994,791) |
| Payments to Employees | (25,968,218) |
| Payments for Claims | (110,019,114) |
| Payments for Dividends | (68,282,196) |
| Other Operating Receipts | 1,236,857 |
| Net Cash Provided by (Used for) Operating Activities | (60,679,967) |
| **Cash Flows from Capital and Related Financing Activities** | |
| Acquisition of Fixed Assets | (163,989) |
| Proceeds from Disposal of Fixed Assets | 11,027 |
| Net Cash Used for Capital and Related Financing Activities | (152,962) |
| **Cash Flows from Investing Activities** | |
| Purchase of Investments | (294,749,792) |
| Proceeds from Sales or Maturities of Investments | 286,660,808 |
| Proceeds from Securities Lending Transactions | 394,635 |
| Payments of Security Lending Costs | (120,198) |
| Interest and Dividends on Investments | 40,492,039 |
| Net Cash Provided by (Used For) Investing Activities | 32,677,492 |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | (28,155,437) |
| **Cash and Cash Equivalents - July 1** | 63,247,178 |
| **Cash and Cash Equivalents - December 31** | 35,091,741 |

The notes to the financial statements are an integral part of this statement.

**Montana State Fund**
**Statement of Cash Flows**
*Montana State Fund is a component unit of the State of Montana*

| YEAR ENDED DECEMBER 31, | 2016 |
|---|---|
| **Reconciliation of Change in Net Position to Net Cash Provided by (Used for) Operating Activities** | |
| Change in Net Position | 10,389,898 |
| **Adjustments to Reconcile Change in Net Position to Net Cash Provided by (Used for) Operating Activities** | |
| Depreciation | 1,153,335 |
| Amortization | 128,783 |
| Security Lending Costs | 176,714 |
| Security Lending Income | (394,635) |
| Income on Investments | (49,844,049) |
| Pension Offsets | 363,692 |
| Decrease (Increase) in | |
| Accounts Receivable | (743,678) |
| Other Assets | 82,705 |
| Increase (Decrease) in | |
| Accounts Payable | (34,669,895) |
| Unearned Premium | (130,271) |
| Property Held in Trust | 83,593 |
| Reinsurance Funds Withheld | (9,313,503) |
| Estimated Claims Payable | 21,235,136 |
| OPEB Liability | 598,874 |
| Compensated Absences | 203,334 |
| Total Adjustments | (71,069,865) |
| **Net Cash Provided by (Used for) Operating Activities** | (60,679,967) |

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## 1. Summary of Significant Accounting Policies

### Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is a discretely presented component unit of the State of Montana and results are included in the State's Comprehensive Annual Financial Report. MSF's results are included in the State of Montana's financial reports because of the significance of MSF's financial relationship with the State. MSF is governed by a seven member Board of Directors appointed by the Governor. The Board has full power, authority, and jurisdiction in the administration of MSF. MSF's Board is allocated to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds and assets held by the Old Fund. Other than the administrative fees paid for the management of the Old Fund claims, no State of Montana General Fund money is used for MSF operations.

The 2015 legislature passed SB 123, which significantly changed the regulatory oversight of MSF effective January 1, 2016. MSF was issued a Certificate of Authority, became an authorized insurer regulated by the Montana State Auditor's Office and became subject to the provisions of Title 33, Montana Insurance Code. MSF was required to change its fiscal year end to a calendar year ending December 31. To make this transition, MSF completed a six-month reporting cycle of July 1, 2015, to December 31, 2015. The accompanying financial statements are as of, and for the year ended, December 31, 2016, and do not include a comparable prior period since these statements represent the first calendar year reporting period.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## Prior Period Adjustment

The State of Montana received a revised Other Postemployment Benefits (OPEB) actuarial valuation subsequent to the issuance of MSF's December 31, 2015, financial statements that changed MSF's allocated share of the OPEB liability. Accordingly, MSF restated its beginning net position to reflect this change. The net impact of the adjustment was $47K (thousand).

## Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, in the proprietary fund category. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF for the year ending December 31, 2016.

An enterprise fund is used to account for operations: (a) financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; (b) where laws or regulations require that the activity's costs of providing services be recovered with fees and charges, rather than with taxes or similar revenues; or (c) where the pricing policies of the activity establish fees and charges designed to recover its costs, where the primary focus of these criteria is on fees charged to external users.

## Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for their workers' compensation insurance operations. Under the accrual basis, revenues are recorded in the accounting period earned, if measurable, and expenses are recorded in the period incurred, if measurable.

### Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly-liquid investments that are both readily-convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value. MSF participates in the Montana Board of Investments' Short Term Investment Pool (STIP), an external investment pool. STIP is managed to preserve principal while providing 24-hour liquidity for state agency and local government participants. Funds may be invested for one or more days. The STIP investments and the income are owned by the participants of the pool and are managed on their behalf by BOI. The STIP portfolio is reported at net asset value. STIP balance as of December 31, 2016, was $30,460,436.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The Montana Board of Investment's (BOI) policy requires that STIP investments have

a minimum of two credit ratings as provided by any Nationally Recognized Statistical Rating Organizations (NRSRO) that meet the minimum as stated in the STIP policy on the type of investment.

Investments
MSF holds investments in long-term debt securities, mutual funds, and real estate partnerships through the BOI. Under the provisions of the state constitution, MSF's invested assets are managed by the BOI. Securities are stated at fair value as defined and required by GASB Statement 72, "Fair Value Measurement and Application". Premiums and discounts are amortized using the scientific method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

The BOI follows the provisions of GASB Statement No. 40, Deposit and Investment Risk Disclosures. The investment risk disclosures are described in the following paragraphs.

Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of U.S. Government securities, MSF's fixed income instruments have credit risk as measured by major credit rating services.

The U.S. Government guarantees the U.S. Government securities directly or indirectly. Obligations of the U.S. Government or obligations explicitly guaranteed by the U.S. Government are not considered to have credit risk. The S&P rating service provide the credit ratings presented in the following tables. If an S&P rating is not available, a Nationally Recognized Statistical Rating Organization (NRSRO) rating is used.

MSF's investment policy for credit risk requires fixed income investments, at the time of purchase, to be rated investment grade as defined either by Moody's or by another NRSRO.

Asset-backed securities are bonds backed by cash flows from principal and interest payments emanating from a trust containing a pool of underlying assets. These securities, while sensitive to prepayments due to interest rate changes, generally have less credit risk than unsecured bonds. Their credit risk is based on the structure itself rather than balance sheet risk. This includes such factors as default rates, overcollateralization, and quality of collateral.

Custodial Credit Risk for Deposits

Custodial risk for deposits is the risk that, in the event of the failure of the custodial institution, the cash or collateral securities may not be recovered from an outside party. For any cash balances held as deposits of the Custodial bank or sub-custodial bank, they are held in the name of the BOI. Per policy, the BOI's custodial institution must hold short-term and long-term credit rating by at least one NRSRO with a minimum requirement of A1/P1 (short-term) and A3/A-1 (long-term).

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

Custodial Credit Risk for Investments

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the BOI may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. All the public securities as well as securities held by the separate public equity account managers were registered in the nominee name for the Montana Board of Investments and held in the possession of the BOI's custodial bank, State Street Bank. The Equity Index funds were purchased and recorded in the BOI's name. Commingled fund investments are registered in the name of the Montana Board of Investments. Investments in external investment pools and open-end mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of any single investment per issuer name. Investments explicitly guaranteed by the U.S. Government are excluded from the concentration of credit risk requirement. In October 2008, the U.S. government extended the explicit guarantee to certain government agencies such as Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC-Freddie Mac). Given the explicit guarantee extension, the BOI had no concentration of credit risk exposure to Fannie Mae and Freddie Mac within the MSF portfolio.

The policy for MSF states, "Fixed income holdings rated lower than A3 by Moody's or A- by S&P are limited to 25% of the market value of the State Fund Investment Portfolio (SFIP)." In the case of split-rated securities, the lowest rating will apply. MSF is limited to stock investments not to exceed 15% of the market value of its total invested assets. The portfolio has a maximum of 8% of the market value to be held in core real estate funds. In addition, MSF's investment policy sets a maximum of 10% of the market value of the portfolio limit for dollar-denominated quasi and foreign government securities. A maximum of 20% of the market value of the portfolio may be held in dollar-denominated international corporate bonds, with exposure to a single foreign jurisdiction not to exceed 10% of the market value. A maximum of 20% of the market value may be held in U.S. Agency mortgage-backed securities (MBS & CMO) and a limit of 5% of market value in commercial mortgage-backed securities (CMBS). A maximum of 3% of the market value of the portfolio may be held in a single parent company issuer, foreign/quasi government issuer, or ABS-specific pool at the time of purchase, excluding U.S. Government/Agency securities. There was no concentration of credit risk exceeding policy guidelines as of December 31, 2016.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Montana BOI uses effective duration as a measure of interest rate risk for MSF portfolio. The BOI's analytic software uses an option-adjusted measure of a bond's (or portfolio's)

sensitivity to changes in interest rates. Duration is the average percentage change in a bond's price for a given change in interest rates. Prices move inversely to interest rates. The effective duration method incorporates the effect of embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-through securities, Collateralized Mortgage Obligation (CMO), and Adjustable Rate Mortgage (ARM) securities).

MSF's investment policy states the duration of the portfolio is to remain within 20% of the established benchmark's duration. Investment policy benchmarks the portfolio against the Barclays' Capital Government / Credit Intermediate Term Index for fixed income investments.

According to the STIP Investment Policy, "the STIP portfolio will minimize interest rate risk by:

1) Structuring the investment portfolio so securities mature to meet cash requirements for ongoing operations, thereby normally avoiding the need to sell securities on the open market prior to maturity;
2) Maintaining a dollar-weighted average portfolio maturity (WAM) for 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities); and
3) STIP will maintain a reserve account."

The fixed coupon holdings pay a fixed rate of interest until maturity while floating rate securities pay a variable rate of interest until maturity. The portfolio held certain variable rate issues. Interest payments on these securities are based on an underlying reference rate, e.g., LIBOR.

The following table categorized investment in order to disclose credit and interest rate risk as of December 31, 2016. Credit risk reflects the bond quality rating, by investment type, as of the report date. Interest rate risk is disclosed using effective duration. If a bond investment type is unrated, the quality type is indicated by NR (not rated). The credit quality ratings have been calculated excluding non-rated investment types. NA (not applicable) indicates the duration has not been calculated.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

Montana State Fund
Credit Quality Rating and Effective Duration as of December 31, 2016
(in thousands)

| Security Investment Type | | Fair Value | Credit Quality Rating | Effective Duration |
|---|---|---|---|---|
| Treasuries | $ | 225,605 | AAA | 4.84 |
| Agency/Government Related | | 231,509 | AAA | 4.47 |
| Asset Backed Securities | | 64,166 | AAA | 2.00 |
| Mortgage Backed Securities | | 23,358 | AAA | 5.52 |
| Financial-Corporate | | 302,067 | A- | 3.01 |
| Industrial-Corporate | | 279,283 | A | 4.16 |
| Utility-Corporate | | 41,053 | A- | 3.21 |
| Short Term Investment Pool (STIP) | | 30,460 | NR | 0.11 |
| **Total Fixed Income Investments** | **$** | **1,197,501** | **AA-** | **3.83** |
| | | | | |
| Direct Investments | | | | |
| Core Real Estate | $ | 91,258 | | |
| Commingled Equity Index Funds | | 165,474 | | |
| **Total Direct Investments** | **$** | **256,732** | | |
| | | | | |
| **Total Investments** | **$** | **1,454,233** | | |
| | | | | |
| Securities Lending Collateral Investment Pool | $ | 45,361 | NR | .08* |

*Securities Lending Collateral Investment Pool is comprised of the Securities Lending Quality Trust Liquidity Pool.

## Securities Lending

MSF participates in a securities lending program through the BOI. The BOI is authorized by law to lend its securities and has contracted with the custodial bank, State Street Bank and Trust, "the Bank", to lend securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The Bank is required to maintain collateral equal to 102 percent of the fair value of domestic securities and 105 percent of the fair value of international securities while the securities are on loan. On any day, including December 31, the markets may move in a positive or negative direction resulting in under or over collateralization. The Bank compensates for market movement by recalculating on the following business day to meet the collateralization requirements. The BOI and the Bank split the earnings, 80/20% respectively, on security lending activities. The BOI retains all rights and risks of ownership during the loan period.

During the year ended December 31, 2016, the Bank loaned MSF's public securities and received as collateral: U.S. dollar cash, U.S. Government and government-sponsored agency securities,

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

U.S. corporate debt securities and structured securities rated AA-/Aa3 or higher, sovereign debt securities of the G10 nations, and debt securities issued by certain supranational agencies. The Bank does not have the ability to sell collateral securities unless the borrower defaults. As of October 31, 2016, STIP no longer participates in the Security Lending program.

The BOI imposed no restrictions on the amount of securities available to lend during the year ended December 31, 2016. There were no failures by any borrowers to return loaned securities or pay distributions thereon during the period that resulted in a declaration and notice of Default of the Borrower. There were no losses during the year ended December 31, 2016, resulting from a borrower default.

The following table presents the market values of the securities on loan and the total collateral held as of December 31, 2016:

| | **Amount** |
|---|---|
| Securities on loan - market value | $ 166,283,927 |
| Collateral Cash | 45,360,715 |
| Collateral Securities | 124,520,060 |
| Collateral Total | $ 169,880,775 |
| % of Fair Value | 102% |

During the year ended December 31, 2016, the BOI and the borrowers maintained the right to terminate all securities lending transactions on notice. The cash collateral received for each loan was invested, together with the cash collateral of other qualified plan lenders, in the State Street Global Securities Lending Trust. Because the securities lending transactions were terminable at will, their duration did not match the duration of the investments made with the cash collateral received from the borrower. At year-end December 31, 2016, State Street Bank indemnified BOI's credit risk exposure to borrowers.

The average duration and average weighted final maturity for the investment fund is as follows as of December 31, 2016:

| State Street Global Securities Lending Trust | |
|---|---|
| Average Duration | 33 days |
| Average Weighted Final Maturity | 100 days |

Income earned related to securities lending for the year ended December 31, 2016, was $345K. Expenses related to securities lending for the year ended December 31, 2016, were $121K.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

Receivables

At December 31, 2016, MSF had a net receivable balance of $81.5M. The gross receivables for billed premium and claim benefits overpayments are $5.6M, which are then reduced by the estimated uncollectible receivables reported as an allowance for doubtful accounts of $1.9M. Other receivables include $63.1M in unbilled premium, $8.6M in investment income due, $133K in retrospective premium and $313K in notes receivable, all of which are short term. Accounts receivable also includes $5.6M at December 31, 2016, for premium that is earned but unbilled (EBUB).

Reinsurance Receivables

As part of the aggregate stop loss reinsurance program, MSF records a receivable for each contract year's funds withheld amount until the loss performance for that contract year is known. The receivable is increased as interest accrues and decreased with the development of recoverable or in the event of a commutation. The reinsurance receivables were $62.6M at December 31, 2016.

Equipment, Accumulated Depreciation and Intangible Assets

Equipment and intangible assets are capitalized if the actual or estimated historical unit cost exceeds $5K and $100K, respectively. Depreciation expense is computed on a straight-line basis for equipment over a period of three to ten years and amortization of intangible assets is computed on a straight-line basis over four years. Amortization of intangible assets is recorded directly to the asset balance. All fixed assets are shown net of depreciation.

Other Assets

Other assets include advances and prepaid expenses.

Land and Buildings

As of December 31, 2016, MSF financial statements include $1.1M in land and $25.0M in buildings, net of depreciation. Buildings are depreciated on a straight-line basis over a period of 50 years. For additional disclosure related to capital assets, see Note 3.

Accounts Payable

Accounts payable is a short-term liability account reflecting amounts owed for goods and services received by MSF.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

Estimated Claims Payable

The estimated claims payable, also called loss reserves, is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Willis Towers Watson, an external actuarial firm, prepares an actuarial study that provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. The MSF Board of Directors approved estimates within that range as the estimated claims payable for MSF. For additional disclosure related to the estimated claims payable, refer to Note 5.

Unearned Premium

Unearned premium reflects premium that has been written but not yet earned. The unearned premium was $68.2M at December 31, 2016.

Policyholder Deposits

Policyholder deposits consist of security deposits required for deposit-type policies and secure the policy with cash, letter of credit or certificate of deposit.

Reinsurance Funds Withheld

Reinsurance funds withheld represents the reinsurance funds held on behalf of the reinsurer, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 4.

Net Position

Net Position consists of the net excess or deficit of assets plus deferred outflows of resources over liabilities plus deferred inflows of resources. Net Position as of December 31, 2016, was $525.3M.

Premiums

The MSF Board of Directors approves premium rates annually. These rates are then filed with the Montana State Auditor's Office for approval in accordance with MCA, Title 33. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the policy year as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## 2. Investments

The Company has the following recurring fair value measurements as of December 31, 2016:

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | | Quoted Prices in Active Markets for **Identical Assets (Level 1)** | Significant Other **Observable Inputs (Level 2)** | Significant **Unobservable (Level 3)** |
| Investments by fair value level | | | | |
| Fixed Income Investments | | | | |
| Treasuries | $ 225,605,070 | $ 225,605,070 | $ - | |
| Agency/Government related | 231,508,570 | - | 231,508,570 | |
| Asset-backed securities | 64,166,168 | - | 64,166,168 | |
| Mortgage-backed securities | 23,357,603 | - | 23,357,603 | |
| Financial-corporate | 302,066,774 | - | 302,066,774 | |
| Industrial-corporate | 279,282,529 | - | 279,282,529 | |
| Utility-corporate | 41,053,323 | - | 41,053,323 | |
| Total Fixed Income Investments by fair value level | 1,167,040,037 | 225,605,070 | 941,434,967 | |
| Investments measured at the net asset value (NAV) | | | | |
| Core Real Estate | 91,258,265 | | | |
| Commingled Equity Index Funds | 165,474,113 | | | |
| Short Term Investment Pool (STIP) | 30,460,436 | | | |
| Total Investments at NAV | 287,192,814 | | | |
| Total investments at fair value | $ 1,454,232,851 | | | |

MSF Investments Measured at NAV

| | December 31, 2016 | | | |
|---|---|---|---|---|
| | Fair Value | Unfunded Commitments | Redemption Frequency (If Currently Eligible) | Redemption Notice Period |
| Core Real Estate | $ 91,258,265 | | Monthly, Quarterly | 45-90 days |
| Commingled Equity Index Funds | 165,474,113 | | Daily | 1 day |
| Short Term Investment Pool (STIP) | 30,460,436 | | Daily | 1 day |
| Total Investments at NAV | $ 287,192,814 | | | |

MSF categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles as follows:

- Level 1—Quoted prices for *identical* assets or liabilities in active markets.
- Level 2—Prices determined using inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, either directly or indirectly.
- Level 3—Prices determined using unobservable inputs.

Fixed income and equity index funds classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Fixed income investments classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices. MSF

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

does not classify any holdings within Level 3 of the fair value hierarchy.

MSF holds two core real estate funds which make equity investments in operating and substantially-leased institutional-quality real estate in the traditional property types (apartments, office, retail, industrial and hotel) via commingled funds. The primary investment objectives of these core real estate funds are to invest in real estate that will generate income from predictable sources of revenue and not realize gains on the underlying assets. This investment type receives distributions of generated income and occasionally through the liquidation of the underlying assets of the fund. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of MSF's ownership interest in the partners' capital. Redemption of these investments is restricted based on the availability of cash flow arising from investment transactions, sales, and other fund operations occurring in the ordinary course of business. Therefore, requested redemptions from a fund will be redeemed as funds become available. As of December 31, 2016, there are no unfunded commitments.

MSF holds two commingled equity index funds which invest in domestic equities and funds that invest in international equities. The fair values of the investments of this type have been determined using the NAV per share (or its equivalent) of the investments.

The Short Term Investment Program (STIP) is managed and administered under the direction of the Board of Investments as authorized by the Unified Investment Program. It is a commingled pool for investment purposes and requested redemptions from the pool are redeemed the next business day. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of the investment.

The amortized cost and estimated market value of MSF's fixed maturity securities as of December 31, 2016, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Market Value |
|---|---|---|
| Due one year or less | $ 69,023,331 | $ 70,013,059 |
| Due after one year through five years | 756,135,208 | 772,027,056 |
| Due after five years through ten years | 322,432,952 | 320,995,775 |
| Due after ten years | 4,000,000 | 4,004,147 |
| Total | $ 1,151,591,491 | $ 1,167,040,037 |

During the year ended December 31, 2016, MSF realized gross gains from sales of securities of $11.4M and gross realized losses of ($113K). During the year ended December 31, 2016, investment income for MSF was $49.8M, which includes unrealized losses on investments in the amount of ($1.2M).

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## 3. Capital Assets

Capital assets are used for the business activities of MSF. Balances for the year ended December 31, 2016 are as follows:

| | Beginning Balances | Increases | Decreases | Ending Balances |
|---|---|---|---|---|
| Capital assets not being depreciated: | | | | |
| Land | $ 1,139,460 | $ - | $ - | $ 1,139,460 |
| Total capital assets not being depreciated | 1,139,460 | - | - | 1,139,460 |
| Capital assets being depreciated: | | | | |
| Buildings/improvements | 27,941,323 | - | - | 27,941,323 |
| Equipment, furniture, and vehicles | 7,505,209 | 164,290 | (285,727) | 7,383,772 |
| Total capital assets being depreciated | 35,446,532 | 164,290 | (285,727) | 35,325,095 |
| Less accumulated depreciation for: | | | | |
| Buildings/improvements | (2,971,560) | (523,434) | - | (3,494,994) |
| Equipment, furniture, and vehicles | (5,130,535) | (629,901) | 247,954 | (5,512,482) |
| Total accumulated depreciation | (8,102,095) | (1,153,335) | 247,954 | (9,007,476) |
| Total capital assets being depreciated, net | 27,344,437 | (989,045) | (37,773) | 26,317,619 |
| Intangible assets | 358,913 | - | (128,783) | 230,130 |
| Total capital assets, net | $ 28,842,810 | $ (989,045) | $ (166,556) | $ 27,687,209 |

## 4. Reinsurance

For the year ended December 31, 2016, MSF ceded premiums to reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that aggregate losses will exceed expected levels expressed as a percentage of premiums.

The excess of loss contract provides coverage up to $100 million with an MSF retention of $5 million on the first layer of coverage. The excess of loss protection applies to an individual occurrence with a maximum of $5 million on any one life. The coverage for the year ending December 31, 2016 is as follows:

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

| Contract Period | Reinsurance Coverage |
|---|---|
| 2016 | Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant. |
| | Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant. |
| | Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant. |

The term of the current aggregate stop loss contract is July 1, 2014, through December 31, 2016. The contract provides coverage based on MSF's premium levels, not to exceed 15% of the subject net earned premium. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $10.4M for the year ended December 31, 2016. The aggregate stop loss contract requires that MSF maintain a funds withheld liability account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The funds withheld liability account at December 31, 2016, is $75.7M for contracts in place from July 1, 2008, to December 31, 2016. Interest must be accrued on the funds withheld account which resulted in accrued interest of $3.8M for the year ended December 31, 2016.

Estimated claim reserves were reduced by $5.1M as of December 31, 2016, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excess of loss reinsurance contracts. The estimated claim reserves were reduced by an additional $13.1M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

As part of the aggregate stop loss reinsurance program, MSF records a reinsurance receivable for each contract year's funds withheld amount until the loss performance for that contract year is known. The receivable is increased as interest accrues and decreased with the development of the recoverable or in the event of a commutation. The reinsurance receivables were $62.6M at December 31, 2016.

MSF also has assumed reinsurance relationships with Zurich American Insurance Company and Argonaut Insurance Company related to Other States' Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. For the year ended December 31, 2016, assumed premium is $2.9M and incurred losses from OSC benefits were $1.3M. The assumed liability for OSC claims is $3.3M at December 31, 2016.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

During the year ended December 31, 2016, MSF commuted one of its outstanding aggregate stop loss contracts covering the period of July 1, 2002 through July 1, 2005. MSF received $100K from Imagine International Reinsurance Ltd. and removed $9.4M of reinsurance recoverables from its reserves, as well as $17.5M of funds withheld liability and $8.1M of accrued contingent commission. This commutation resulted in losses incurred of ($100K). In addition, MSF commuted ten of its outstanding excess of loss contracts with Reliastar Life Insurance Company. The contracts covered the period July 1, 1992 to July 31, 2002. MSF received $5.1M and removed $6.8M of reinsurance recoverables from its reserves, resulting in losses incurred of $1.7M and loss adjustment expenses incurred of $10K. Accrued reinstatement premium related to one of the contracts was reversed, resulting in earned premium of $90K.

## 5. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF financials. At December 31, 2016, approximately 24,200 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the guaranteed market insurer for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF, or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. Willis Towers Watson, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of December 31, 2016. Because actual claim costs depend on such complex factors such as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Willis Towers Watson provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for December 31, 2016. The MSF estimated unpaid claims and claims adjustment expenses payable presented at face value, net of estimated reinsurance recoverable were $921.5M, as of December 31, 2016. The Statement of Net Position displays this total separated as current and noncurrent estimated claims payable.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Changes in Claims Liabilities

The following table presents changes in the aggregate liabilities for MSF, net of estimated reinsurance recoverable. The information presented has not been discounted.

| | 2016 |
|---|---|
| Unpaid claims and claim adjustment expenses at beginning of period | $ 900,296,496 |
| Incurred claims and claim adjustment expenses: | |
| Provision for insured events of the current year | 139,240,472 |
| Increase(Decrease) in provision for events in prior years | (7,986,222) |
| Total incurred claims and claim adjustment expenses | 131,254,250 |
| Payments: | |
| Claims and claim adjustment expenses attributable to insured events of the current year | (23,086,407) |
| Claims and claim adjustment expenses attributable to insured events of prior years | (86,932,707) |
| Total payment | (110,019,114) |
| Total unpaid claims and claim adjustment expenses at end of the period | $ 921,531,632 |

## 6. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M. MSF allocated $814K in administration costs to the Old Fund for the year ended December 31, 2016. The administration costs are recorded in non-operating revenue as other income. Beginning in June 2011, the State of Montana General Fund began making transfers to cover the cost of administering and paying the Old Fund claim benefits.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## 7. MSF Distributions

Dividends declared in September 2015 of $35M were paid in January 2016. Additionally, the Board of Directors declared a $35M dividend in September 2016, of which $34.1M was paid in 2016.

## 8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program (Traditional Plan) and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers union represented employees who have elected to remain in the plan. These employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to non-exempt employees in the Traditional Plan. The MSF Personal Leave Program covers all non-union employees, union employees hired before July 26, 2006, who have elected to adopt the plan, and all employees hired after July 25, 2007. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination, but extended leave has no cash value at the time of termination.

The total MSF compensated absences liability is $3.0M as of December 31, 2016.

## 9. Retirement Plans

MSF and its employees contribute to the Public Employees' Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB), a defined benefit retirement plan (PERS-DBRP) and a defined contribution retirement plan (PERS-DCRP).

Defined Benefit Retirement Plan

*Benefits provided*. The PERS-DBRP is a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are established in state law and may only be amended by the State of Montana Legislature. Members are vested after five years of membership service, which entitles the member to an accrued normal retirement benefit payable at age 60 (or age 65 if hired after June 30, 2011). A member may receive a refund of accumulated contributions in lieu of a pension, thereby forfeiting the right to a monthly benefit. A description of the benefits and eligibility rules for the plan are shown in the following table:

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

*Member's highest average compensation (HAC)*

Hired prior to July 1, 2011 - highest average compensation during any consecutive 36 months;
Hired on or after July 1, 2011 - highest average compensation during any consecutive 60 months;
Hired on or after July 1, 2013 - 110% annual cap on compensation considered as part of a member's highest average compensation.

*Eligibility for benefit*

Service retirement:

Hired prior to July 1, 2011: Age 60, 5 years of membership service;
Age 65, regardless of membership service; or
Any age, 30 years of membership service.

Hired on or after July 1, 2011: Age 65, 5 years of membership service;
Age 70, regardless of membership service.

Early retirement, actuarially reduced:

Hired prior to July 1, 2011: Age 50, 5 years of membership service; or
Any age, 25 years of membership service.

Hired on or after July 1, 2011: Age 55, 5 years of membership service.

*Vesting*

Occurs once 5 years of membership service is completed

*Monthly benefit formula*

Members hired prior to July 1, 2011:

Less than 25 years of membership service: 1.785% of HAC per year of service credit;
25 years of membership service or more: 2% of HAC per year of service credit.

Members hired on or after July 1, 2011:

Less than 10 years of membership service: 1.5% of HAC per year of service credit;
10 years or more, but less than 30 years of membership service: 1.785% of HAC per year of service credit;
30 years or more of membership service: 2% of HAC per year of service credit.

*Guaranteed Annual Benefit Adjustment (GABA)*

After the member has completed 12 full months of retirement, the member's benefit increases by the applicable percentage each January, inclusive of all other adjustments to the member's benefit.

-- 3% for members hired prior to July 1, 2007
-- 1.5% for members hired on or after July 1, 2007 but prior to July 1, 2013
-- For members hired on or after July 1, 2013, 1.5% if the plan is funded at or above 90%; 1.5% less 0.1% for each 2% the plan is funded below 90%; 0% if the plan amortization period is 40 years or more.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

Changes to benefit terms since the prior measurement date include the addition of GABA provisions for retirees hired on or after July 1, 2013, addition of second retirement benefit terms, and the additional 1.0% employer contribution being directed to the Plan Choice Rate Unfunded Actuarial Liability rather than the Defined Benefit Unfunded Actuarial Liability (effective July 1, 2015).

*Contributions.* Contribution requirements for the plan are established in Montana Code Annotated Title 19, Chapter 3, Part 3, and can only be amended by the State of Montana Legislature. All members contribute 7.9% of their compensation. This is a temporary 1% increase for members hired prior to July 1, 2011 and remains the same for members hired on or after July 1, 2011. Interest is credited to member accounts at the rates determined by the PERB. All member contributions will be decreased to 6.9% on January 1 following the actuarial valuation results that project the amortization period to drop below 25 years and remain below following the termination of the 1% additional member contribution rate.

MSF contributes 8.37% of each member's compensation. This was increased from 6.9% to 7.035% on July 1, 2007, 7.17% on July 1, 2009, and to 8.17% on July 1, 2013. The rate will continue to increase .1% each year until 2024. These increased contributions will terminate on January 1 following the actuarial valuation results that project the amortization period to drop below 25 years and remain below following the termination of the additional employer contribution rates. Effective July 1, 2013, contributions are also made to the plan from the Coal Severance Tax Fund. The plan recognized $1,458,634 in MSF (employer) contributions during the plan year ended June 30, 2016.

Further information regarding description of the plan is available Montana Public Employees Retirement Administration website: http://mpera.mt.gov/docs/2016CAFR.pdf

*Actuarial assumptions*. The plan costs and liabilities in the June 30, 2015, actuarial valuation were determined using the following economic assumptions:

| | |
|---|---|
| General wage increases | 4.00% |
| Investment return | 7.75% |
| Price inflation assumption | 3.00% |
| Growth in membership | 0.00% |
| Interest on member accounts | 3.50% |
| Admin. Expenses as a percentage of payroll | 0.27% |

Mortality rates were based on the RP-200 Combined Employee and Annuitant Mortality tables, with adjustments for mortality improvements using scale AA. These actuarial assumptions are based on the most recent experience study of the plan, which was completed in 2010.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

*Discount rate.* The discount rate used to measure the total pension liability was 7.75%, which is the assumed long-term expected rate of return on plan assets. The projection of cash flows used to determine the discount rate assumes contractual contribution rates. Based on those assumptions, the pension plan's fiduciary net position is projected to be sufficient to make all projected future benefit payments of current active and inactive employees. Accordingly, the long-term expected rate of return on pension investments was applied to all periods of projected benefit payments to determine the liability.

The 7.75% long-term expected rate of return on plan investments was determined using a combination of analysis which includes log-normal distribution analysis in which best-estimate ranges of expected future real rates of return are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. In addition, a Peer System Comparison analysis is also conducted of similar retirement systems which compares the assumed rate of return to the median assumed rate of return of other retirement systems which are similar in terms of asset size. The target allocation and best estimates of arithmetic real rate of return for the asset classes are shown in the following table:

| Asset Class | Target Allocation | Expected Rate of Return |
|---|---|---|
| Broad US Equity | 36.0% | 4.55% |
| Broad Intl Equity | 18.0% | 6.35% |
| Private Equity | 12.0% | 7.75% |
| Intermediate Bonds | 23.4% | 1.00% |
| High Yield Bonds | 2.6% | 4.00% |
| Core Real Estate | 4.0% | 4.00% |
| Non-Core Real Estate | 4.0% | 4.00% |

The following table displays MSF's proportionate share of the net pension liability using the 7.75% discount rate as well as the proportionate share using 6.75% and 8.75%, a decrease of 1% and an increase of 1%, respectively.

| | 1% Decrease (6.75%) | Discount Rate (7.75%) | 1% Increase (8.75%) |
|---|---|---|---|
| MSF's Proportionate Share of the Net Pension Liability | $ 34,293,082 | $ 23,632,903 | $ 14,450,199 |

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

*Plan fiduciary net position*. Detailed information about the plan's fiduciary net position is available in the separately issued PERB Comprehensive Annual Financial Report available at the following address: http://mpera.mt.gov/docs/2016CAFR.pdf

*Pension liabilities, expense, and deferred inflows and outflows of resources*. At December 31, 2016, MSF reported a liability for its proportionate share of the plan's total net pension liability in the amount of $23,632,903, representing a 1.387440% share of the total based on amount of contributions by each employer. The net pension liability was measured as of June 30, 2016, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of June 30, 2015, with updated procedures used to roll forward the liability to June 30, 2016. There were no significant events between the measurement date and reporting date that are expected to have an impact on MSF's proportionate share of the liability.

For the year ended December 31, 2016, MSF recognized pension expense of $2,213,724 and revenue of $414,054 for support provided by the Coal Severance Tax. At December 31, 2016, MSF reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

| | Deferred Outflows of Resources | Deferred Inflows of Resources |
|---|---|---|
| Actual vs. Expected Experience | $ 127,516 | $ 78,225 |
| Changes of assumptions | - | - |
| Actual vs. Expected Investment Earnings | 2,223,384 | - |
| Changes in Proportion and Differences Between Actual Contributions and Proportionate Share Contributions | 325,054 | - |
| Contributions Subsequent to the Measurement Date | 731,448 | - |
| Total | $ 3,407,402 | $ 78,225 |

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

The $731,448 reported as deferred outflows of resources related to pensions resulting from MSF contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended December 31, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

| State of Montana's year ended June 30: | |
|---|---|
| 2017 | $ 107,644 |
| 2018 | 107,644 |
| 2019 | 1,263,468 |
| 2020 | 793,920 |
| 2021 | - |
| Thereafter | - |

Defined Contribution Retirement Plan

The PERS-DCRP is a multiple-employer plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefit terms are established in state law by the State of Montana Legislature. Those terms are as follows:

*Eligibility for benefit*
Termination of service

*Vesting*
Immediate for participant's contributions and attributable income;
5 years of membership service for the employer's contributions to individual accounts and attributable income.

*Benefit*
Depends upon eligibility and individual account balance;
various payout options are available, including: taxable lump sums, periodic payments per participant direction and IRS permitted rollovers.

Member and employer contribution rates are established in state law by the State of Montana Legislature. The member contribution rate for the year ended December 31, 2016, was 7.9% of member compensation, while the MSF contribution rate was 8.37% of member compensation for the first half of the year and 8.47% for the second half. Both the member and employer rates have been temporarily increased by the Legislature and will decrease to 6.9% on January 1 following actuarial valuation results that show the amortization period of the PERS-DBRP has dropped below 25 years and will remain below 25 years following the reduction of both the additional employer and additional member contribution rates.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

For the year ended December 31, 2016, MSF contributed $1.7M to the defined benefit and defined contribution plans combined. MSF cannot determine the portion of that total that relates to the defined contribution plan. Of that amount, $101K remains outstanding at December 31, 2016.

Deferred Compensation Plan

MSF and its employees are eligible to participate in the State of Montana 457(b) Deferred Compensation Plan administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred supplemental retirement plan sponsored by the Montana Public Employee Retirement Board and held in trust for the exclusive benefit of public employees and their beneficiaries. The Plan is authorized by IRC Section 457(b) and is subject to specific Internal Revenue Service's laws and requirements. It allows employees to voluntarily contribute a portion of their compensation on a pre-tax basis. The amount invested, plus interest credited on any fixed options and any gain on the variable options, is not taxable until withdrawn at a future date. MSF incurs no costs for this plan. A summary of eligibility and benefits is shown in the following table:

*Contribution*
Voluntary, pre-tax deferral or designated Roth contribution.

*Eligibility for benefit*
Not available to participant until separation from service, retirement, death, or upon an unforeseeable emergency, while still employed, provided IRS-specified criteria are met.

*Vesting*
Participants are fully vested in their accounts immediately.

*Benefit*
Lump sum or periodic benefit payment at the option of the participant. Based on individual account balances and plan provisions. IRS permitted rollovers are also possible.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## 10. Leases and Commitments

MSF leases office facilities outside of Helena under various operating leases that expire through February 2021.

MSF leases 350 parking spaces from the City of Helena in a parking garage adjacent to the MSF facility. The cost of the parking spaces is the same monthly rate as equivalent parking passes sold by the City and has the potential to change based on parking rates assigned by the Helena Parking Commission until the lease expires on June 30, 2040.

Rental expenses for the year ended December 31, 2016, were $365K, which includes $291K for the parking garage lease, $57K for office space leases, and $18K for minor office equipment.

The future minimum rental payments for office and parking space are as follows:

| | Amount |
|---|---|
| 2017 | $ 362,237 |
| 2018 | 353,687 |
| 2019 | 326,883 |
| 2020 | 308,724 |
| 2021 | 306,954 |
| Thereafter | 5,672,099 |
| | $ 7,330,584 |

## 11. Other Post-Employment Benefits (OPEB)

Beginning with the fiscal year ending June 30, 2008, the State of Montana implemented Governmental Accounting Standards Board (GASB) Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions. This statement requires the disclosure of employer liability for retiree medical subsidies and other post-employment benefits.

OPEB Plan Description

MSF employees and dependents are eligible to receive health care through the State Group Benefits Plan administered by the Montana Department of Administration. In accordance with section 2-18-704, MCA, the State provides optional post-employment medical, vision and dental health care benefits to the following employees and dependents who elect to continue coverage and pay administratively established premiums: (1) employees and dependents who retire under applicable retirement provisions and (2) surviving dependents of deceased employees. For GASB

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

45 reporting, the State Group Benefits Plan is considered an agent multiple-employer plan and MSF is considered to be a separate employer participating in the plan.

The OPEB plan allows retirees to participate, as a group, at a rate that does not cover all of the related costs. This results in the reporting of an "implicit rate subsidy" in the related financial statement and footnotes. While this liability is disclosed for financial statement purposes, it does not represent a legal liability of the State or MSF. Accordingly, reported contributions are not a result of direct funding to the plan or for associated liabilities, but are a measure of the difference in retiree payments into the plan and actual benefit costs associated with those individuals paid for by the plan.

The OPEB plan does not issue a standalone financial report.

Funding Policy

The State of Montana pays for post-employment healthcare benefits on a pay-as-you-go basis. Section 2-18-8, MCA gives authority for establishing and amending the funding policy to the Department of Administration.

For the year ended December 31, 2016, the OPEB plan's administratively-established retiree medical contributions vary between $416 and $1,506 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental contributions vary between $41.10 and $70, and vision hardware contributions vary between $7.64 and $22.26 depending on the coverage selected.

OPEB Costs and Contributions

The annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45, represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year of retiree health care costs and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

The ARC is calculated for all the State plan's participants and then allocated to individual participants. The MSF allocated portion of the ARC for the year ended December 31, 2016, is estimated at $740K and is based on the plan's current ARC rate of 5.26% percent of participants' annual covered payroll.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

The following table presents the OPEB cost, amount contributed, and changes in the OPEB liability for the year ended December 31, 2016:

| | |
|---|---|
| Annual required contribution | $ 739,986 |
| Interest on net OPEB obligation | 251,769 |
| Amortization factor | (197,466) |
| Annual OPEB cost | 794,289 |
| Contributions made | (195,415) |
| Increase in net OPEB obligation | 598,874 |
| Net OPEB obligation - beginning of year | 5,725,976 |
| Net OPEB obligation - end of year | $ 6,324,851 |

The MSF annual OPEB cost, percentage of OPEB cost contributed, and OPEB liability for the current and two prior reporting periods are as follows:

| Fiscal Period Ended | Annual OPEB Cost | Percentage of Annual OPEB Cost Contributed | Net OPEB Obligation |
|---|---|---|---|
| 12/31/2016 | 794,289 | 24.60% | 6,324,851 |
| 12/31/2015 | 801,848 | 32.18% | 5,679,169 |
| 6/30/2015 | 796,772 | 28.19% | 5,135,382 |

The most recent actuarial valuation available as of the reporting date was as of January 1, 2015, for the year ending December 31, 2015. The valuation occurs every other year. MSF's allocation of the plan as of the most recent valuation is as follows:

| | |
|---|---|
| Actuarial Accrued Liability (AAL) | $8,134,298 |
| Actuarial Value of Plan Assets | $0 |
| Unfunded Actuarial Accrued Liability (UAAL) | $8,134,298 |
| Funded Ratio (Actuarial Value of Plan Assets/AAL) | 0% |
| Covered Payroll (Active Plan Members) | $20,491,203 |
| UAAL as a Percentage of Covered Payroll | 39.70% |

Actuarial Methods and Assumptions

Actuarial valuations of an OPEB plan involve estimates of the value of reported amounts and assumptions about the probability of events far into the future, including future employment, mortality, and health care trends. The actuarially-determined amounts are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future. Actuarial calculations reflect a long-term perspective and are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation. The schedule of funding progress, presented as required supplementary information following the notes to the

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

financial statements, provides information regarding the multi-year trend of the actuarial value of plan assets and liabilities.

The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. As of the January 1, 2015, actuarial valuation date, the projected unit cost funding method is used. The actuarial assumptions did not include an investment rate of return since no assets meet the definition of plan assets under GASB 43 or 45. Annual healthcare cost trend rates of 3.4 and 10.8 percent were used for medical and prescription claims, respectively. The unfunded actuarial accrued liability is amortized following a 30-year level percent of pay amortization on an open basis, using a 4.25 percent interest/discount rate and a 2.50 percent payroll growth rate assumption.

## 12. Contingencies

*Susan Hensley v. Montana State Fund* Montana State Fund received a Petition for Hearing that was filed before the Workers' Compensation Court in October 2013. The matter is Susan Hensley vs. Montana State Fund, WCC No. 2013-3235. The matter is fully briefed and is submitted for a decision. Under HB 334, as passed by the legislature in 2011 and codified in 39-71-703 (2), MCA, when a claimant receives a Class I impairment, it is not payable unless the claimant has an actual wage loss as a result of the compensable injury or occupational disease. The law was effective July 1, 2011 and applicable to claims that occurred on or after that date. The petitioner in this matter is challenging the constitutionality of 39-71-703 (2), MCA. State Fund anticipates the chances are remote, but as with any litigated matter there is the possibility of an adverse decision. Should the statute be held unconstitutional, determined to be applicable to other claims and also determined to be retroactively applicable, potential liability is estimated to be at least $2.2 million per year, as based on NCCI initial pricing, and current estimated business volumes. However, based on experience, costs may be substantially higher than the estimate of $2.2 million per year.

Montana State Fund received another Petition for Hearing that was filed before the Workers' Compensation Court. The matter is Steven Hanson vs. Montana State Fund, WCC No. 2014-3398. This is a companion case to Susan Hensley v. Montana State Fund and has been held in abeyance pending a decision in Hensley.

Montana State Fund also is involved in litigation in the areas of workers' compensation and disputes with policyholders. These are of a generally routine nature and there are no known matters at this time that will have a material adverse financial impact.

**Montana State Fund**
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2016

## 13. Subsequent Events

Subsequent to December 31, 2016, BOI decided to divest its investment in the TIAA-CREF US Cities Fund LP. Sales will likely take place throughout 2017 and proceeds from the sales will be used to repurchase similar investments. No impairment of the values in these statements is deemed necessary.

## REQUIRED SUPPLEMENTARY INFORMATION

**Risk Management (Financial Statement Note 5)**

The following table illustrates how MSF's earned revenues plus investment income compare to related costs of loss and other expenses incurred for fiscal years 2008 through 2015, the six-month period ended December 31, 2015 (shown as 2015.5), and calendar year 2016. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims trends. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

**Risk Management Trend Information**

| (In Thousands) | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2015.5* | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| 1. Premiums and Investment Revenue | | | | | | | | | | |
| Earned | 300,924 | 265,487 | 226,212 | 221,916 | 186,779 | 184,203 | 194,180 | 187,316 | 98,323 | 187,743 |
| Ceded | 14,676 | 13,702 | 13,224 | 11,286 | 11,501 | 8,459 | 9,460 | 11,310 | 5,545 | 10,447 |
| Net Earned | 286,248 | 251,785 | 212,988 | 210,629 | 175,278 | 175,743 | 184,721 | 176,007 | 92,777 | 177,295 |
| 2. Unallocated expenses including overhead | 47,778 | 49,215 | 44,188 | 57,282 | 49,557 | 49,515 | 46,206 | 52,570 | 27,822 | 55,392 |
| 3. Estimated losses and expenses, end of accident year | | | | | | | | | | |
| Incurred | 177,100 | 159,229 | 137,507 | 142,989 | 118,066 | 128,522 | 139,145 | 124,831 | 66,142 | 128,147 |
| Ceded | - | - | - | 9,769 | 1,099 | - | - | - | - | - |
| Net Incurred | 177,100 | 159,229 | 137,507 | 133,220 | 116,967 | 128,522 | 139,145 | 124,831 | 66,142 | 128,147 |
| 4. Net paid (cumulative) as of: | | | | | | | | | | |
| End of policy year | 31,002 | 29,009 | 25,475 | 27,902 | 24,729 | 25,706 | 26,808 | 24,150 | 16,181 | 23,086 |
| One year later | 67,034 | 60,009 | 52,701 | 56,502 | 54,982 | 50,574 | 55,957 | 59,787 | 27,202 | |
| Two years later | 86,268 | 74,132 | 66,235 | 69,918 | 70,487 | 64,327 | 74,159 | 60,844 | | |
| Three years later | 95,612 | 83,737 | 74,028 | 76,385 | 80,144 | 73,805 | 75,811 | | | |
| Four years later | 103,337 | 89,431 | 78,884 | 81,578 | 85,661 | 74,955 | | | | |
| Five years later | 109,144 | 93,622 | 82,764 | 85,276 | 88,453 | | | | | |
| Six years later | 113,630 | 96,935 | 85,972 | 87,238 | | | | | | |
| Seven years later | 118,024 | 100,366 | 87,220 | | | | | | | |
| Eight years later | 124,128 | 101,621 | | | | | | | | |
| Nine years later | 124,257 | | | | | | | | | |
| 5. Re-estimated ceded losses and expenses | 4,971 | - | - | 4,067 | 9,059 | - | - | - | - | - |
| 6. Re-Estimated net incurred losses and expense: | | | | | | | | | | |
| End of policy year | 177,100 | 159,229 | 137,507 | 133,220 | 116,967 | 128,522 | 139,145 | 124,831 | 74,233 | 128,147 |
| One year later | 174,279 | 152,886 | 139,554 | 134,175 | 130,507 | 123,912 | 134,698 | 140,598 | 69,180 | |
| Two years later | 173,808 | 151,738 | 135,833 | 133,652 | 130,281 | 119,972 | 136,257 | 120,835 | | |
| Three years later | 172,888 | 151,303 | 135,253 | 133,796 | 119,821 | 120,415 | 126,431 | | | |
| Four years later | 172,570 | 150,212 | 134,681 | 135,734 | 119,313 | 115,453 | | | | |
| Five years later | 167,166 | 149,230 | 133,836 | 134,896 | 115,802 | | | | | |
| Six years later | 166,367 | 149,291 | 132,963 | 133,600 | | | | | | |
| Seven years later | 169,470 | 148,915 | 131,396 | | | | | | | |
| Eight years later | 170,153 | 146,656 | | | | | | | | |
| Nine years later | 166,774 | | | | | | | | | |
| 7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year | (10,326) | (12,573) | (6,111) | 380 | (1,165) | (13,069) | (12,714) | (3,996) | 3,037 | - |

* Column represents the six-month period ended December 31, 2015.

## Retirement Plans (Financial Statement Note 9)

**Schedule of MSF's Proportionate Share of the Net Pension Liability***

| June 30: | 2016 | 2015 | 2014 |
|---|---|---|---|
| Proportionate Share of the Net Pension Liability | 1.39% | 1.39% | 1.35% |
| Proportionate Share of the Net Pension Liability | $ 23,632,903 | $ 19,369,771 | $ 16,863,200 |
| Defined Benefit Pensionable Payroll | 16,452,061 | 15,976,817 | 15,132,665 |
| Proportionate Share as % of Pensionable Payroll | 143.65% | 121.24% | 111.44% |
| Plan Fiduciary Net Position as a % of Total Pension Liability | 74.71% | 78.40% | 79.90% |

| June 30: | 2016 | 2015 | 2014 |
|---|---|---|---|
| Contractually Required Contributions | $ 1,389,115 | $ 1,332,551 | $ 1,351,735 |
| Contributions in Relation to the Contractually Required Contributions | 1,458,634 | 1,442,885 | 1,351,735 |
| Contribution Deficiency (Excess) | (69,519) | (110,334) | - |
| Defined Benefit Pensionable Payroll | 16,452,061 | 15,976,817 | 15,132,665 |
| Proportionate Share as % of Pensionable Payroll | 8.87% | 8.34% | 8.93% |

*This schedule is intended to show ten years of data. Additional years will be presented as they become available.

Changes to benefit terms since the prior measurement date include the addition of GABA provisions for retirees hired on or after July 1, 2013, addition of second retirement benefit terms, and the additional 1.0% employer contribution being directed to the Plan Choice Rate Unfunded Actuarial Liability rather than the Defined Benefit Unfunded Actuarial Liability (effective July 1, 2015).

## Other Post-Employment Benefits (Financial Statement Note 11)

As of December 31, 2016, the most recent actuarial valuation available that was completed by the State of Montana was as of January 1, 2015 for the year ending December 31, 2015. This actuarial evaluation is completed every two years with the next valuation to be completed as of January 1, 2017 for the year ending December 31, 2017.

The State of Montana finances claims on a pay-as-you-go basis and does not advance-fund the OPEB liability. Therefore, the funded ratio remains at 0% at December 31, 2016.

**Schedule of Funding Progress**

| Date | Actuarial Value of Assets (A) | Actuarial Accrued Liability (AAL) (B) | Unfunded AAL (UAAL) (B-A) | Funded Ratio (A/B) | Covered Payroll (C) | UAAL as a Percentage of Covered Payroll (B-A)/C) |
|---|---|---|---|---|---|---|
| 1/1/2015 | $0 | $8,134,298 | $8,134,298 | 0.00% | $20,491,203 | 39.70% |
| 1/1/2013 | $0 | $7,288,059 | $7,288,059 | 0.00% | $18,899,275 | 38.56% |
| 1/1/2011 | $0 | $6,355,058 | $6,355,058 | 0.00% | $19,544,196 | 32.52% |

# Report on Internal Control and Compliance

LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray



# Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Legislative Audit Committee
of the Montana State Legislature:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Montana State Fund, as of and for the calendar year ended December 31, 2016, and the related notes to the financial statements, which collectively comprise Montana State Fund's basic financial statements, and have issued our report thereon dated June 8, 2017.

***Internal Control Over Financial Reporting***

In planning and performing our audit of the financial statements, we considered Montana State Fund's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Montana State Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of Montana State Fund's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal controls was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify

Room 160 • State Capitol Building • PO Box 201705 • Helena, MT • 59620-1705
Phone (406) 444-3122 • FAX (406) 444-9784 • E-Mail lad@mt.gov

any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

***Compliance and Other Matters***

As part of obtaining reasonable assurance about whether Montana State Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

***Purpose of this Report***

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of Montana State Fund's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Montana State Fund's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Respectfully submitted,

*/s/ Cindy Jorgenson*

Cindy Jorgenson, CPA
Deputy Legislative Auditor
Helena, MT

June 8, 2017

# Montana State Fund

## State Fund Response

MONTANA
STATE FUND

P.O. Box 4759 • Helena, MT 59604-4759
Customer Service 1-800-332-6102
Fraud Hotline 1-888-682-7463 (888-MT-CRIME)

July 26, 2017

RECEIVED
JUL 26 2017
LEGISLATIVE AUDIT DIV.

Mr. Angus Maciver
Legislative Auditor
Legislative Audit Division
State Capitol Building, Room 160
Helena, MT 59601

Dear Mr. Maciver:

Montana State Fund (MSF) appreciates the professionalism of the Legislative Audit Division staff in completing the financial-compliance audit of our calendar year 2016 governmental financial statements. We are pleased with your issuance of an unmodified opinion with no recommendations.

The management and staff of MSF prioritize high-level service to Montana employers and employees. As we continually strive to improve our operations to ensure Montanans will benefit from a strong Montana State Fund many years into the future, we thank you for your assistance and assurance.

Sincerely,

Laurence A. Hubbard
President/CEO

Enclosures

cc: Lance Zanto